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SUBJECT: Canada's Foreign Investment Reforms Create A More Open
Market But Do Not Spare U.S. Steel from Canadian Court Action

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11. (SBU) Summary: Canada's July 17 federal court action against U.S. Steel attempts to force the company to meet the production and employment commitments it made to the Federal Government in 2007 in exchange for permission to take over Canada's Stelco. At that time, the GOC exercised its legal right make foreign acquisition of Canadian assets conditional on the fulfillment of certain performance requirements. However, at the same time as the Federal Industry Ministry is cracking down on investor behavior, the Conservative government is also implementing changes to the national investment regime that would make Canada a more open and transparent investment destination for foreign investors. Although most of the proposed regulations are not controversial, some foreign investors will be dismayed that Canada's new security requirements demand increased disclosure of confidential information and increase the possibility that the government might disallow an investment on security grounds even after the transaction has been completed. End summary.

U.S. Steel

12. (U) On July 17, Minister of Industry Tony Clement announced that the Government of Canada was launching an action against U.S. Steel in the Superior Court of Canada to remedy an alleged breach of Canadian investment law. The American steelmaker's 2007 acquisition of Ontario-based Stelco was predicated upon the company maintaining minimum levels of Canadian employment, capital expenditures and production. In May 2009, the industry minister threatened legal action after U.S. Steel cut production and laid off employees at its Canadian operations in tandem with the global economic recession.

ICA Undertakings

13. (U) Canada's Investment Canada Act (ICA) permits the Industry Minister to bind foreign investors to obligations on matters such as local production and employment levels in order to ensure that the investment provides a 'net benefit' to Canada. Following a recent exchange of letters with the company, Clement stated, "I remain of the view that U.S. Steel is not complying with its undertakings, and I am not satisfied by its explanations for non-compliance." If the Canadian court finds that an investor has breached an ICA undertaking, remedies include curing the breach, fines or forced

divestiture of the investment. In this case, the Industry Minister has asked the courts to levy a C\$10,000-a-day fine against U.S. Steel, retroactive to the November 2008 Canadian layoffs.

14. (SBU) Although the terms of the undertakings a company makes to the government are generally confidential, the Canadian media is reporting that when U.S. Steel bought the bankrupt Stelco in 2007 for C\$1.16 billion, it promised to boost production at Stelco mills by 10 per cent in each of the first three years of ownership and to maintain 3,105 full-time employees. Today, some 2,400 workers have either retired or been laid off by U.S. Steel, and the company has halted steel output in Hamilton and Nanticoke, Ont. In its court filing, the government alleges that the company has defaulted on 77 percent of its employment commitment. (Comment: Since U.S. Steel Qpercent of its employment commitment. (Comment: Since U.S. Steel has not responded publically to the GOC court action it is not known whether the company's undertakings included any exemptions for exogenous economic downturns. End comment.) This is the first time the Canadian government has taken a foreign company to court over promises made as part of an acquisition (although it has threatened similar action against the Brazilian mining company Vale Inco which has laid off approximately 400 workers).

15. (SBU) Some Canadians are criticizing the government's move for the negative message it will send to other potential foreign investors. A Globe and Mail editorial argues that although Ottawa may be legally entitled to its actions, Stelco's 2007 commitments are unreasonable in today's volatile economic climate. The paper speculates that Canada's hard line against Stelco may be intended as a warning to General Motors and Chrysler that they will be similarly held to the employment commitments they made in exchange for federal

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bailout funds. Nevertheless, the Globe concludes, "Ottawa should refrain from intervening in future foreign takeovers. In a world where economic volatility can render hard-won promises impracticable, it simply isn't worth it."

16. (SBU) Christopher Sands, a senior fellow at Washington's Hudson Institute, notes that the Canadian action puts U.S. Steel in the difficult position of having to sideline one government's policy in order to comply with another's. The steel industry has been hit hard by the slump in construction and one of U.S. Steel's best customers is the U.S. government, which has imposed strict Buy American rules. This means that U.S. Steel has a stronger incentive than usual to cut Canadian production to maintain higher volumes at U.S. mills. Consequently, Sands suggests, the future decisions of U.S Steel "will be determined by which government they fear more."

Changes to ICA

17. (U) In spite of the actions regarding Stelco, the Harper Government is moving forward with commitments to open up the Canadian economy to more foreign investment. In March 2009 preliminary changes to the Investment Canada Act (ICA) were introduced as part of the government's budget legislation. These were followed on July 11, 2009 with a number of proposed regulations to give effect to the investment changes contained in the budget. Among the most important amendments are increased investment thresholds -- to determine which foreign investments will be subject to a full governmental review -- and the imposition of a new national security screening mechanism. Canada also plans to eliminate differential review thresholds for transportation and financial services and uranium production. The proposed regulations will take effect after a 30-day comment period and do not require a vote in the House of Commons.

Higher thresholds, new formulas, same cultural barriers

18. (SBU) The ICA requires that direct foreign takeovers of large Canadian companies be reviewed and approved based on whether or not the investment constitutes a "net benefit to Canada." (Comment: The net benefit criteria are not spelled out in legal terms and are

open to a range of interpretations depending on the disposition of the government in power. End comment.) Frequently, the government will ask the foreign investor to provide negotiated undertakings such as those assumed by U.S. Steel. Under the old rules, an ICA review is required for any direct takeover by foreign investors from a WTO country of a Canadian company with more than C\$312 million in gross assets. The new regulations will increase the review threshold, first to C\$600 million and ultimately to C\$1 billion by the end of four years.

¶9. (SBU) Although the higher thresholds mean fewer foreign investments will likely be subject to full review, all foreign investments must be notified to the government. Also the methodology for determining the review threshold will be expanded from considering only the asset value of the proposed acquisition to a broader evaluation based on a company's market capitalization, assets, and liabilities. Despite the new regulations, Canada's Qassets, and liabilities. Despite the new regulations, Canada's pre-existing regime banning virtually all foreign investment in cultural industries remains unchanged, even though the 2008 government report Compete to Win recommended reforms in this area.

Enhanced national security requirements

¶10. (U) Under the proposed regulations, a foreign investor will have to disclose the names of directors, the five highest paid officers, any person or entity holding more than ten percent of the investor's equity or voting rights, and the name of any foreign state that holds a direct or indirect ownership interest in the investor, even minor shareholders. The security disclosure requirements apply to all foreign investments (including acquisitions and the establishment of new businesses), even those that fall below the

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review threshold.

¶11. (SBU) The new regulations set out time frames for the government to invoke the national security screening process - generally within 45 days after a notice of investment or review application has been filed. However, in cases of investments valued below the applicable review threshold, the government has up to 45 days after an investment has been implemented to determine whether it should be submitted to a full security screening. (Comment: Presumably, this longer period exists to prevent smaller acquisitions that are not subject to other forms of review from slipping under the radar and to provide adequate time for the government to obtain more information about the proposed investment and investor. End comment.)

¶12. (U) The security review could take as long as four months and will be conducted primarily by Canada's security and intelligence agencies. If an investment is found to be a threat to national security then the investment can be unwound or restricted.

Implications of Canadian changes for US investors

¶13. (SBU) Although the subjective net benefits test has not been eliminated from Canada's foreign investment review process, the higher review threshold means that fewer investments will be subjected to it. As well, the addition of a more transparent process to ensure that investments are not injurious to national security brings Canada's policy more closely into alignment with that of the United States. The clarification of Canada's security requirements comes too late to affect the failed 2008 attempt by US-based Alliant Techsystems, Inc. to take over the space-assets arm of Canada's MacDonald Dettwiler and Associates Ltd (MDA), which Ottawa vetoed on national security grounds. However during a meeting with Embassy officials last week, a senior Industry Canada official speculated that if the new security framework had been in place at the time of Alliant's bid, the outcome could have been quite different.